REHEARING 6-2-98

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN **COMMISSIONER-CHAIRMAN** **RENZ D. JENNINGS** **COMMISSIONER** **CARL J. KUNASEK** **COMMISSIONER**	**ATTORNEY GENERAL'S MOTION FOR RECONSIDERATION** **DOCKET NO. U-0000-94-165**

The Attorney General, a party to this proceeding, through counsel and in accordance with A.R.S. § 40-253, and Arizona Corporation Commission procedural rule R14-3-111, hereby moves the Commission to reconsider its Order and Opinion on stranded costs issued June 2, 1998 (the "Order"). The Attorney General seeks a reconsideration order as follows:

1. Amending Option 1 to remove lost-revenues awards and striking Option 2.

2. Amending Finding of Fact No. 8 to conform to Rule A.A.C. R14-2-1601(8).

3. Striking Finding of Fact No. 9.

4. Amending Finding of Fact No. 10 to remove "Regulatory Assets; and Social costs".

5. Amending Finding of Fact No. 17 to be consistent with the evidence in the record and to state that one of the biggest changes affecting costs has been the rapid decline in the cost of wholesale power.

6. Striking Finding of Fact No. 23.

7. Striking Finding of Fact No. 29 and finding that 1996 customers of the Affected Utilities should pay any competition transition charge ("CTC") *pro rata*.

8. Amending Finding of Fact No. 34 to provide for no longer than a five (5) year pay out for stranded costs.

9. Reconsidering the Order to evaluate the impact on competition of the various resolutions contained in it and amending any such resolutions that either create barriers to

competition or fail to remove existing barriers.

10. Amending the Order to incorporate the Attorney General's proposed rule amendments eliminating Certificate of Convenience and Necessity (CC&N) procedures and to allow statewide territories at the commencement of competition before divestitures occur.

MEMORANDUM OF POINTS AND AUTHORITIES

The grounds for this motion are as follows:

Several aspects of the Commission's Order, including several findings of fact, are unreasonable, capricious, outside the Commission's authority and constitute an abuse of the Commission's discretion. The portions of the Order objected to here contain or are based on findings that are not supported by substantial evidence, that contravene the great weight of evidence, that contravene the intention of the Commission in enacting the Competition Rules, and that contravene the rules themselves, among other infirmities. The specific portions of the Order of which the Attorney General seeks reconsideration and a summary of his objections are as follows:

1. Options 1 and 2: Option 1 must be amended and Option 2 must be stricken. The Commission cannot, consistent with the limitations in the Rules, the evidence before it in the stranded cost evidentiary hearings and their responsibilities at law, permit Affected Utilities to recover future costs of generation. This result is proscribed by the language of the Commission's own Competition Rules (see point 2, below), by the Arizona case law governing the so-called "regulatory compact" theory of stranded costs, and by the evidence of record. Option 1 allows recovery of not only "stranded costs defined by A.A.C. R14-2-1601.8" but all "reasonable costs" incurred by divestiture, income tax effects, debt redemptions and other future costs. While all of these are factors in determining whether

the divested assets are above or below "book" value so as to protect the investment from devaluation, none of them are permitted **in addition to** the "market value". The Commission's Order even adds employee severance and retraining costs, none of which are "market value" costs at all, and are no more than costs of going forward as a business in competition. These "add ons" to lost market value are an unreasonable burden on customers and competition. Option 1 should be amended to delete these additional charges which are contrary to law and not supported by the record. (See the detailed analysis of why the Commission cannot order a lost-revenues based stranded cost approach in Attorney General's Memorandum of Points and Authorities re: Stranded Costs filed March 16, 1998, attached hereto as Exhibit 1. Also see Attorney General's Exceptions to Proposed Opinion and Order, filed May 29, 1998, attached hereto as Exhibit 2. Both papers and the arguments, points and authorities contained therein are incorporated in their entirety here by this reference.)

Option 2, the "Transition Revenues Methodology" appears to be a net lost revenues approach to apply in cases where the Affected Utility simply needs more money to stay in business. This Option should be stricken entirely. There is no justification in the letter or the spirit of the Commission's Rules or its move to competition to burden Arizona customers and electric competition with the salvage of a failing firm. If a utility in Arizona cannot meet its debts, it should indeed sell its assets, restructure its debts or otherwise make prudent management decisions to curtail operations so as to eliminate unprofitable divisions. Divestiture allows this to happen and thereafter, if truly stranded costs remain, they may be paid in the pro-competitive manner that market-based stranded cost methodologies provide. Distorting consumption and price to save a failing firm is not within the Commission's authority to move the industry to competition.

2. Finding of Fact No. 8: "The difference between market based prices and the cost of regulated power has been generally referred to as stranded costs." This definition is

contrary to Rule A.A.C. R14-2-1601(8) which specifically defines stranded costs as follows:

> 8. "Stranded Cost" means the verifiable net difference between:
> a. The value of all the prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchased power contracts, fuel contracts, and regulatory assets), acquired or entered into prior to the adoption of this article, under traditional regulation of affected Utilities ; and
> b. The **market value** of those assets and obligations directly attributable to the introduction of competition under this Article. (Emphasis added.)

Finding of Fact No. 8 is not only wholly inconsistent with the express definition of stranded costs, it is a new definition injected into the stranded costs proceeding after the fact. Those like the Attorney General who expended considerable resources litigating stranded costs issues relied on the Rules' definition of stranded costs in choosing their evidence and argument. Finding No. 8 materially alters the relevance and weight of that evidence, by recasting the parameters of stranded costs as lost revenues instead of lost "market value". To allow this new definition, on which the lost revenues aspects of Options 1 and 2 are both premised, amounts to a denial of due process to the parties to this proceeding who relied on the definition in the rule.

The Competition Rule definition does not allow a "lost revenues" consideration in stranded costs at all, except insofar as lost revenues affect market value fixed as of a date certain. Because it is inconsistent with the Rule, finding No. 8 also contravenes the great weight of evidence, which focussed on how to place a "market value" on generation assets. (See Exhibit 1.) The only testimony that supports this new definition of stranded costs, is that of Arizona Public Service ("APS") and Tucson Electric Power ("TEP") and their captive shareholder group, each of whom stands to gain millions if lost revenues is a legitimate basis for calculating any aspect of stranded costs. Finding of fact No. 8 is simply not supported by substantial evidence.

3. Finding of Fact No. 9: "According to APS, there will be excess generation capacity in the Southwest Region up through 2006." This finding should be stricken.

While the finding is an accurate restatement of APS's testimony, it is not a reasonable finding based upon the evidence on the record. This finding is used to justify the Commissions finding No. 34, which allows stranded costs to be recovered over ten years. Excess capacity is not a legitimate premise for the payment of stranded costs or the time for recovery. The period of excess capacity merely means wholesale prices are lower, during which period shortening or eliminating stranded cost transition charges is the main mechanism for allowing the full impact of generation price competition.

4. Finding No. 10: "Stranded costs consist of the following general categories: Generation related assets; Regulatory Assets; and Social costs. " The finding should be amended to state "Generation related assets whose market value has changed due to competition" and to strike "Regulatory Assets and Social costs." The only principle justifying stranded costs is the change in value of generation assets, if any, caused by competition. Social costs are among the costs every business incurs upon a market change, and are entitled to no special reimbursement. Regulatory assets are not recoverable as stranded costs *per se*, since they may as easily be costs of distribution, and not generation, and therefore not subject to devaluation by deregulation.

5. Finding of Fact No. 17: "Rate reductions over the last several years reflect mitigation efforts put forth by the Affected Utilities in contemplation of competition" should be amended to add "and the declining cost of wholesale power" to be consistent with the evidence in the record. There was evidence that the Affected Utilities took mitigation steps, but also considerable evidence that one of the biggest changes affecting costs has been the rapid decline in the cost of wholesale power.

6. Finding of Fact No. 23: "A short transition period and rate reductions are in direct contradiction." This finding should be stricken. A short transition on an award of minimal stranded costs is not inconsistent with rate reductions. The only inconsistency is where the Commission intends to award hundreds of millions of dollars in stranded costs at

the outset. If the Commission's intention, as has been publically expressed by the Chairman, is to limit stranded costs to those to which the Affected Utilities clearly prove themselves entitled, then this finding has no place in the Commission's stranded cost Order.

7. Finding of Fact No. 29: "All current and future customers of the Affected Utilities should pay their fair share of regulatory assets and social costs" should be stricken and replaced with the words "All historical customers of the Affected Utilities receiving service as of December 31, 1996 should pay their fair share of stranded costs, based on their 1996 usage. Stranded cost transition charges should be paid pro-rata based on this historic usage." The evidence before the commission was that distorting future consumption, which an additional charge on new consumption surely does, thwarts the supply-demand aspects of a competitive marketplace. In addition, there was no rebuttal to the testimony that it is unfair to free large historical users (on the basis of whose large consumption additional generation capacity was built) from their *pro rata* share of stranded costs. As the Order now stands, the burden of transition costs falls more heavily on small users than large.

8. Finding of Fact No. 34: "Stranded cost or other transition revenue authorized by the Commission should be collected over no longer than ten years..." should be modified by striking "ten years" and replacing it with "five years". Ten years is too long and is consistent only with an over-award of stranded costs. The Commission was obliged to properly limit stranded costs by eliminating lost revenues options which would eliminate the need for a competition-burdening ten-year transition period.

9. Failure to Consider Impact on Competition: The point of the stranded cost proceedings is to facilitate the move to retail electric competition. The effect on competition - that is, whether any particular policy or rule will help or hurt competition - is thus a central issue. In the Commission's 24-page Order, however, the impact on

competition is mentioned only once, in Finding of Fact No. 26, and elsewhere is wholly disregarded. As the Attorney General has argued repeatedly before, and as economist after economist testified in the stranded cost hearings, a true market measure of stranded costs is the least likely to create barriers to new entry and market uncertainty or to distort both price and consumption so that the effects of true price competition can be felt. The Commission's Order ignores this weighty evidence and indeed ignores its own competition rules in failing to find, as a matter of fact, what the barriers to competition are and how the Order removes or reduces them. Without the balance of the effect on competition, the Order is at best incomplete, and at worst creates its own new barriers to competition.

On a proper reconsideration of barriers to competition, the Commission can undo the lost revenues aspects of the Order, direct divestiture, and remove barriers to statewide competition through eliminating CC&N procedures that restrict geographic markets. (See point 10, below). Any amount above zero stranded costs, any "wires" charges that may distort future consumption, any "failing firm" rescues, lost revenues-based stranded costs, CTC charges and restrictions on geographic territories for retail marketing all have a real, immediate and negative effect on competition. The Commission must weigh those factors, given the testimony as presented, and determine that every aspect of its Order will promote, and not deter, competition. In this industry, on this record, there will have to be changes in the Order as proposed here, in order to make a pro-competition finding.

10. Rule Amendments - CC&Ns: The Order refers to certain proposed amendments to the competition Rules, but ignores a lynchpin of the Attorney General's recommendations - the elimination of exclusive CC&N territories. There is no procompetitive justification for continuing limited geographic territories for competitve and deregulated services such as metering and billing as well as generation. Statewide marketing potential can further minimize stranded costs, particularly upon a divestiture. A power plant that can become licensed to serve the entire State of Arizona simply has a

higher value than one which can only apply in a limited market territory and then must face the challenge of a monopoly incumbent. It is critical that the Commission as a whole review the matter of CC&N certification, consider the testimony that elimiation of CC&N territories will advance competition and amend its Order to mandate rule changes that will eliminate these government-perpetuated monopolies (or duopolies) in retail electric services.

CONCLUSION

The Commission is at a crucial point in electric industry restructuring. It has shown a willingness in many areas to move boldly forward to competition. The Order at issue here should be consistent with that view of the future by breaking down barriers to competition, by not engaging in unlawful transfers of wealth from customers to utilities, and by not burdening future customers with an unfair and useless stranded cost "tax". The days of permitting Affected Utilities to recover every cost are over, and every dollar of stranded costs must be measured by "market value" and must be weighed against the burden it places on Arizona's future. The Attorney General hereby requests that the Commission review and reconsider its Order, and amend it as proposed here.

RESPECTFULLY SUBMITTED, this 13th day of July, 1998.

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BEFORE THE ARIZONA CORPORATION COMMISSION

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COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA	**DOCKET NO. RE-00000C-94-0165** **ATTORNEY GENERALS' MEMORANDUM OF POINTS AND AUTHORITIES RE: STRANDED COSTS**

The Attorney General, a party to this proceeding, hereby submits the following Memorandum of Points and Authorities in support of his proposed method for calculating and allocating stranded costs, if any, occasioned by the Commission's December 31, 1996 rules opening electric power generation to competition. The Attorney General urges this Commission to adopt a market method of calculating stranded costs and an efficient pro-competitive method of allocating and paying these costs, if any.

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MEMORANDUM OF POINTS AND AUTHORITIES

I.

THE COMMISSION MUST USE FREE-MARKET ANALYSIS IN FASHIONING ITS STRANDED COSTS POLICY

After an entire year of working groups that failed to reach consensus and a month-long evidentiary hearing, the Commission now faces the considerable challenge of crafting an order determining how stranded costs will be calculated, allocated and paid. The Commission's stranded cost decision will have profound effects on the future of electric energy consumption in this State. The Attorney General urges the Commission to adopt a single overriding principle not only as to the various parties claims to equity, but also as to budding competition. That principle is: "First, do no harm." (Scott, Opening Statement for RUCO, 2/9/97, tr. p. 52, l. 19-21.)[1]

A. The Commission's Order Must Further the Goal of Competition by January, 1999

Undisputably, free market competition, as compared to any type of ongoing regulation, is the best guarantee of high quality, low price, cost-effective, technologically advanced and efficient generation and demand management of the commodity electric power. (Direct testimony of Kenneth Gordon, 1/9/98, p. 3, l. 1-9; Davis, tr. p. 3863, l. 7-13.) Simply put, moving toward the "genius of the marketplace" is in the public interest. (Testimony of Dr. Daniel Fessler, 2/10/98, p. 453, l. 20-25, p. 448, l. 19-20.)

By December, 1996, the die was cast and the Commission established competition as the electric power paradigm for the next millennium. Now, for the first time in over seven decades the

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[1] See also, remarks of Karen Carageen, president of the Small Business Survival Committee. National Association of Attorneys' General Hearing on Electric Industry Restructuring, Washington, D. C., November 13, 1997, p. 120, l. 20 - 21. "First, do no harm in undertaking of restructuring this highly complex and regulated industry." Ms. Carageen is a nationally-recognized spokesperson on tax issues, budget matters, regulation, and government efficiency.

commission must consider and balance the potential for harm to the coming competitive Arizona generation market against the potential injury to ratepayers, shareholders and affected utilities in any order it issues. Under the new vision of Arizona's electric power future, the interest of fostering competition is of equal weight to the other traditional interests. By adopting its restructuring Rules, the Commission codified a new "compact" with the people and companies of Arizona; the Commission has promised Arizona a competitive retail power market and it has promised to get us there.

Of course, the Commission cannot "create" competition. Competition is already firmly established in the wholesale power market, and will continue to flourish wherever it can, with or without the Commission. The Commission's order on stranded costs can do nothing to create competition, but can do much to prevent it. To strike the right balance, the Commission must now get out of the way. By removing regulatory barriers, by avoiding market distortion through stranded cost overcompensation, by ensuring competitive incentives and by limiting its protective role to only those situations where protection cannot be had elsewhere, the Commission can honor its new "competition compact" with the citizens of this State.

Because the value of competition is no longer subject to debate, the Commission should disregard evidence and testimony that seek to establish that the Commission's competition rules are premature, that treat competition as an option or that ask the Commission to consider the "what if" scenarios as if competition were not yet. More importantly, the Commission should disregard proposals that seek to insulate the Affected Utilities from the effects of competition as envisioned by the Rules. The only salient facts now are those related to a rapid, balanced move toward competition beginning January 1, 1999. If any proposal or aspect thereof slows the process down, calls for additional regulation, or transfers the risk of future competition away from the Affected Utilities and their competitors to ratepayers, the Commission must reject it. (See, Gordon, direct testimony, 1/9/98, p. 4, l. 2-27.)

In this regard, the Commission must fairly employ its own procedural and evidentiary rules, and must find as fact only that which first, promotes competition and second, is supported by substantial evidence. In the hearings on stranded costs, there were many ideas and opinions,

but the clear preponderance of the credible evidence was that stranded costs can only be rationally calculated, allocated and paid using a market method. Net loss revenues or extended administrative rate case-type proceedings into the future became, after December, 1996, invalid methodologies.

Mr. Fessler testified to his concern that the restructuring rules lacked a clear vision of what the Commission believes generation competition should look like. (Fessler, 2/10/98, tr. p. 548, l. 2-5.) Dr. Alan Rosenberg, testifying on behalf of the Arizonans for Electric Choice and Competition, et. al., provided this vision as follows:

15 [Q.] I'd like to go through some of the
16 elements of what a competitive market would look
17 like in generation in Arizona and talk to you about
18 those.
19 In the competitive market would there be
20 consumer choice as between more than one provider?
21 A. Yes.
22 Q. And would those providers be efficient
23 providers?
24 A. Would they be efficient providers?
25 Q. In a fully competitive market.
[tr. p. 2225]
1 A. Well, yes, because if they were not
2 efficient providers, they wouldn't be able to stay
3 in competition, they wouldn't be able to stay in
4 business.
5 Q. What does efficiency mean? What benefit
6 does efficiency give to end users, consumers of
7 electricity?
8 A. Efficiency allows the highest output for

the least input.

Q. And does efficiency protect users, ratepayers, from paying too much for administrative costs, too much for overhead costs, too much for more than the market price will really bear for controllable costs?

A. You can think of it that way, yes.

Q. So one aspect and goal of efficiency is to eliminate all of those costs that really ought not in a competitive market end up in rate base?

A. That is correct. Because those producers or suppliers that are most efficient will lower their prices because they won't have that overhead, other competitors will either have to get --

Q. Get lean and mean?

A. Meet that or get out of the business.

[tr. p. 2226]

Q. And the business choke that is going to be the existence of a competitive provider who isn't efficient?

A. Right.

Q. We agree a competitive market in Arizona would have open access, open access to the transmission, to the distribution grid so other generators can get through the grid down to consumers?

A. Absolutely.

...

Q. Now, would you agree in a competitive market most beneficial to end users there would be

[tr. p. 2227]

open territories, that is, any provider could sell in any place to meet market demand?

A. That's right. There will be no protected franchises as far as generation is concerned.

Q. Would you agree that in a competitive market service becomes an important aspect of the marketability of the product?

A. Yes.

Q. So consumers, residential users, would benefit from the incentive to provide increased service, customer service, dispute resolution service, delivery service, again, incentive exists in competition because that makes your product more marketable than the fellow's product that doesn't have that good of a service?

A. And I have seen marketing plans of providers who intend to increase their market share because they will provide a wide range of services.

Q. So the actual price might not be the only thing affecting consumer decisions?

A. Correct.

Q. And consumers, is it a benefit to consumers to have the choice of a high service

higher cost provider than a lower cost lower

[tr. p. 2228]

service provider?

A. Absolutely.

Q. Is there anything in a competitive market that will really get us there, anybody in the regulated monopoly structure that has that same level of incentives to higher levels of service?

A. In my view, no.

Q. Would a competitive market need to have low barriers to enter it?

A. Yes.

Q. Does that mean a new provider with new technology could get in?

A. Yes.

Q. And is that barrier, the elimination of barriers to enter, does that provide ongoing checks against inefficient providers, high-cost providers and so on?

A. Absolutely.

Q. Is that because anyone at anytime can come in, and you might have to compete with somebody from New Jersey next week?

A. Absolutely.

Q. And would you say that a competitive market will have technological advances as part of it?

[tr. p. 2229]

A. I would suspect so.
Q. That is what we have seen in computers and telecommunications after the breakup of the AT&T monopoly?
A. That is correct.
Q. Is that a benefit to everyone, business, consumer, residential user?
A. In my view it is, yes.
Q. Now, in your opinion does any approach to evaluating stranded costs, other than truly market based approach, get us there as efficiently and as soon?

...

Q. (BY MS. DALLIMORE) Get us to the competitive paradigm we were just discussing.
A. You are asking me whether I prefer a market based approach to administrative approach; I said I prefer market based approaches.
Q. In your opinion, the market based approach will get us in Arizona to a competitive marketplace sooner, more efficiently, than the administrative approach?

[tr. p. 2230]

A. My view, yes.

(Rosenberg, 2/18/98, p. 2225-2230, as above.)

B. The Affected Utilities are Positioning Themselves for Competition

Dr. Gordon made it quite clear that this Commission has no role in the Affected Utility's future success in competition. (Gordon, direct testimony, 1/9/98, p. 8, l. 27-29.) The Affected Utilities have been practicing for years how to do business in the competitive wholesale power market. Affected Utilities and shareholder group witnesses alike testified that opening new markets and shrewd internal management decisions about taking advantage of competition are the best future protection for the Affected Utilities and their shareholders. (Davis, 2/26/98, tr. p. 3873, l. 8-25, p. 3874 l. 1-2, p. 3875 l. 11-23, p. 3876, l. 1-17; Meek, 2/27/98, tr. p. 4255, l. 18-25.)

The IOUs and their shareholders have known since 1994 that competition was coming and have published documents to that effect, (Meek, 2/27/98, p. 4253, l. 9-11, p. 4261, l. 14-19, p. 4289, l. 1-8), and have made many internal decisions to get ready, to restructure internally, and to pursue new opportunities in anticipation of competition. APS is marketing retail generation in Southern California this very day, and has separated its commercial operations business unit into a separate accounting function from its generation business unit, so the costs of marketing in Southern California can be easily determined. (Davis, 2/26/98, tr. p. 3869, l. 2-25.) TEP has a retail office in Phoenix. (Meek, 2/27/98, tr. p. 4276, l. 9-11.) These moves are market-forced mitigation, and have happened because of competitive pressure. Left unimpeded, these measures will continue, and restructuring will happen voluntarily where it makes sense to management in the new competitive environment. An example of this phenomenon is Southern Cal Edison who, although required to divest only 50% of its fossil generation assets, voluntarily divested itself of 100%. (Fessler, 2/10/98, tr. p. 423, l. 21-25, p. 424, l. 1 -21.) Southern Cal Edison figured out a way to do better in the marketplace, because it had to. This is the "discipline of the market" which monopolies especially lack. (Goldwater Institute, direct testimony, 1/21/98, p. 11, l. 25-26.)

This evidence demonstrates that the Commission need not issue a draconian order that substitutes its judgment about what will work for the Affected Utilities for their own management's expertise. Rather, the Commission need only identify the stranded cost minimizing, fast and efficient market-based method to be used. The Attorney General's suggested

stock value/split approach does that for APS. Voluntary divestiture or appraisal works for TEP. Voluntary divestiture of above-market contracts reduced by offsetting financial gains does the job for the cooperatives. The Commission will see that the companies themselves will go farther than that, if they need to, to stay in the game.

II.

STRANDED COSTS MUST BE MINIMIZED TO REDUCE MARKET DISTORTION

Stranded costs do not exist in competitive markets. In competitive industries, a "stranded " cost is just a loss to be "eaten by shareholders". (Goldwater Institute, direct testimony, p. 12, l. 2-3.) It is a management misjudgment that results in an obligation or expenditure that sales revenues from market-set prices cannot cover. A cardinal principle in competition is that poor decisions create immediate negative consequences to the bottom line, and that these consequences move companies to better performance. Affected Utilities claim dozens of "going-forward costs" as strandable, such as the "meters" development and retail marketing sought by Citizens, (Breen, direct testimony, 1/9/98, p. 111, l. 26-29, p. 12, l. 1-9), and the nearly unlimited costs sought by APS, (Hieronymus, direct testimony, 1/9/98, p. 7, l. 11 to p. 9, l. 9), including "power supply costs," [2] "O&M Costs including A&G allocation" and other post-1996 non-generation costs "to implement retail competition" sought by APS, (Davis, direct testimony, p. 6, l. 20-21, Schedule JED-2, l. 18), together with future guaranteed rates of return. (Davis, 2/26/98, tr. p. 3707, l. 1-8.)

The very idea of paying for future operating costs is an anomaly wholly inconsistent with the entire premise of this proceeding. TEP's own witness says as much. (Gordon, direct testimony, 1/9/98, p. 4, l. 23-26, p. 15, l. 14-16.) It is clear that some of the Affected Utilities have no concept of how to, or intention to, discipline themselves as to their costs in competition. The Commission should keep in mind that letting the market discipline the future is a desirable

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[2] Apparently these costs are to be paid by APS ratepayers even if they are incurred in the future to supply power to the Southern California retail markets APS is entering, or the SRP markets APS intends to enter . (Compare Davis direct testimony, 1/9/98, Schedule JED-2, l. 15-21, to Davis' testimony, tr. p. 3896, l. 16-19.)

goal, not an unfair punishment.

Paying stranded costs, whatever the theory, puts an artificial cost, (not generated by supply, demand and marginal cost factors), on doing business and necessarily distorts markets by, among other things, artificially altering consumption. (Block, 2/25/98, tr. p. 3464, l. 13- 23.) This cost, the so-called CTC, is a cost paid by consumers, (or new market entrants), for essentially nothing but the privilege to choose a provider. The higher these artificial costs, the higher prices will be, since even efficient firms cannot drive prices all the way down to their own marginal costs. Everyone has to charge and pay the extra price. The paramount goal then, is to pay as close to zero stranded costs as possible, and therefore to choose the method of calculation that will justify the lowest stranded cost recovery. [3]

A. If there is No Lost Shareholder Equity, there are No Stranded Costs

Shareholders are, of course, the real "owners" of the investor owned utilities, APS, TEP and Citizens. (Meek, 2/27/98, tr. p. 4251; Block, 2/25/98, tr. p. 3551, l. 21-25, 3552, l. 1-8; Davis, 2/26/28, tr. p. 3827, l. 14-15.) With or without the "regulatory compact" theory [4], the only rational justification for stranded cost recovery is the view that the owner/shareholders have lost the equity they enjoyed, or the opportunity to recoup a fair rate of return if things go well, not because of any management decision or market event, but because the regulators have changed the entire utility environment by moving to competition. (Block, 2/25/98, tr. p. 3551, l. 21-25, p.

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[3] Mr. Fessler testified that avoiding litigation was a primary reason for paying stranded costs. (Fessler, 2/10/98, tr. p. 461, l. 12-18.) Dr. Block said that recognizing a duty to pay stranded costs was merely a way of resolving the utilities' claims so that the process could move forward. (Block, direct testimony, 1/9/98, p. 12, l. 22-24.) These are important goals. The Attorney General is not advocating zero stranded costs if, in fact, shareholders have lost any portion of their investment. But where a market-based method shows no real loss "due to competition", and payment of stranded costs with its negative consequences to ratepayers and competition would amount to a future hedge for the company against competition, none should be awarded. Affected Utilities will pursue their remedies if they are dissatisfied, whatever the Commission does. TEP has already threatened to sue. (Bayless rebuttal testimony, p. 5, l. 4-5.) Small ratepayers will not be able to resort to the courts. The proper balance is not to pay the utilities everything they want to avoid litigation, but to base the minimal award squarely upon verifiable proof on how much competition, (i.e., the free market), has actually cost the investors as of the time the change goes into effect.

[4] There is little support for this theory in law or in economics. The regulatory compact is a weak justification for stranded costs. (Dr. Coyle, 2/11/98, tr. p. 1101.)

3552, l. 1-23; Goldwater Institute, direct testimony, 1/21/98, p. 9, l. 4-11.)

APS and TEP appear to accept this basic premise, but thereafter their reasoning fails. They equate the "**opportunity**" to recover 100% of stranded **investment**, to the "**guaranteed**" recovery of the **future revenues and rates of return** they expected in a continued regulatory environment. (See, Meek, 2/27/98, tr. p. 4260, l. 23-25, p. 4261, l. 1-7; Davis, e. g., 2/26/98, tr. p. 3707, l. 1-8; Bayless, direct testimony, 1/9/98, p. 6, l. 15-21.) TEP's expert says only that the utilities' owners are entitled to a "reasonable opportunity" to recover "100 percent of those shareholder funds that they have **invested in plant and equipment** that may be strandable owing to the Commission's decision to introduce competition in Arizona", (Fessler, 2/10 /98, tr. p. 458, l. 19-21), but also that recovery itself "was never a 100% guaranteed result", (*id.*, p. , l. 9-10). TEP's expert conclusively states that future gains, profits and losses, (other than continuing Commission mandates), are no part of the stranded costs equation. (Gordon, direct testimony, 1/9/98, p. 12, l. 9-12.)

It follows from this evidence that the Commission can lawfully award shareholders only that amount of stranded costs that repairs their lost equity as of the moment when the change in regulatory environment impacted the investment. The result is the same considering the Commission's past orders awarding the shareholders a reasonable rate of return. Another line of reasoning postulates that what the shareholders gave up by investing in utilities [5] was their potential for the big rewards the market sometimes offers. (Block, direct testimony, Exh. GWI 1, p. 9, l. 6-8, *quoting, Economic Report of the President*, 1996.) In exchange, they got a good, steady rate of return from having to wait to recover the value of their original investment. APS and TEP have skewed this argument and claim that, therefore, those gains must continue at least until the "market imbalance" is over in 2006. (Davis, direct testimony, 1/9/98, p. 10, l. 10-20.) This view misses the point that if the equity is unimpaired, that is, if the shareholders have or will, (through divestiture sales prices or elevated stock values), recover their investment, they are whole

[5] If in fact anything was given up, given that at least some utilities have been among the best investments to be had over the last few years. (Exh. A.G. 4)

and everything else is irrelevant .

Moreover, if the shareholders have already reaped their just rewards, because their equity is not impaired by the move to competition, there are no stranded costs. Any measure of stranded costs that rewards management for inefficient costs, that preserves a future competitive position or market share, or that protects the equity position of the shareholders going forward from the effect of competitive market prices, overcompensates shareholders to the detriment of ratepayers and, potentially, taxpayers. Giving shareholders the **chance** to get back what they actually invested in "bricks and mortar", plus a rate of return on that amount only over the period their recovery of those investments was deferred fully keeps any promise the government allegedly made. Conversely, awarding any fixed or guaranteed revenue stream or rate of return into the future is not supported by substantial evidence in this record and would, therefore, be an abuse of the Commission's discretion. *See, Pima County v. Pima County Merit System Com'n*, 189 Ariz. 566, 944 P. 2d 508, (App. 1997); *Havasu Heights Ranch and Development Corp. v. Desert Valley Wood Products, Inc.*, 167 Ariz. 383, 386- 387, 807 P. 2d 1119, 1122-1123 (App. 1990).

Indeed, such a ruling would be contrary to the law argued to support the regulatory "taking" premise of the alleged compact. **An economic loss from competition**, even where it reduces investors' expected return, and even if it is allegedly unfair competition by the government**, is not a constitutional "taking".** *Laidlaw Waste Systems, Inc. v. City of Phoenix*, 168, Ariz. 563, 565-567, 815 P. 2d 932, 934-936 (App. 1991). A reasonable opportunity to recover the value of property "taken" by government is, in the constitutional sense, only an "adequate process for obtaining compensation", not a fixed amount of money. The "adequate" process can be, as it is in this docket, a process provided by a State. *Williamson County Regional Planning Comm'n v. Hamilton Bank of Johnson City*, 473 U.S. 172, 194-95, (1985).

The "reasonable opportunity" for APS to recover 100% stranded costs is the chance, through this proceeding and the Commission's order, for its shareholders to **keep** the fantastic gains that the company has been able to retain by undoubtedly brilliant management. It is indisputable that APS management has done well for its shareholders in the face of looming competition:

12. Q. (By Ms. Dallimore of Mr. Meek.) Are you aware at the beginning of 1995
13. and the end of 1996, when the rules were made final in
14. this Commission, that APS stock gained $688 million
15. in value?
16. A. I'm glad to hear it.
17. Q. Does that sound right to you?
18. A. That sounds fine to me.
19. Q. And are you aware of the fact that since
20. the rules were made final in December of 1996, the
21. stock has gained 28 more percent in value? Are you
22. aware of that?
23. A. I'm not completely aware of it, but again,
24. I'll accept that.
25. Q. And I think you told me, didn't you tell me

[p. 4254]

...

4. Q. Were you aware of the fact, between December 1996, when this
5. Commission finalized its rules subjecting APS to
6. competition, the stock gained $946 million in
7. value?
8. A. I'm not aware of that specifically, but
9. again, I'll accept that.

(Meek, 2/27/98, p. 4253-54; Exh. A.G. 4.)

A gain of $1.3 billion dollars in value, since it was known in the industry that competition was coming, is a pretty darn good return. The Attorney General proposes that the Commission let the APS/Pinnacle West shareholders keep the gain by valuing the stock as proposed, and to let APS get on with its in-place plans to compete, subject only to restrictions on abuse of its retail market power in its historic monopoly territory.

Of course APS's shareholders, a substantial number of whom are APS executives, want more. Mr. Meek just assumed the 11.25% rate of return for investors was built into APS's net revenues lost recovery program, and lauded it as "protecting their investment". (Meek, 2/27/98, tr. p. 4261.) Mr. Davis made it clear that APS wants to guarantee revenues to pay all costs plus this 11.25% to shareholders, (including himself), for eight (8) more years. (Davis, 2/26/98, tr. p. 3707, l. 1-8.)

This Commission has neither the duty nor the authority to "protect" anyone's above-book value investment. In fact, the Commission has a responsibility in advancing competition, to award zero stranded costs where huge gains in equity have occurred. APS and its parent, Pinnacle West, have done a remarkable job of making that company profitable at a time of dramatic market change. There is no reason they would not continue to do so. Although Mr. Meek opines that capital will "dry up" if the commission issues an order for less than 100% stranded costs, his opinion is completely contradicted by the dramatic increase in the value of the APS/Pinnacle West stock **after** the market investors knew that on January 1, 1999, competition would begin. (Meek, tr. p. 4254, l. 4-10.)

There is no evidence before this Commission that the shareholders of Pinnacle West have lost, or will lose, anything.[6] Mr. Meek's dire prediction is not "substantial evidence" that the stock market methodology will result in less than 100% stranded cost recovery. There is no such evidence in this record. This Commission must not only have at least substantial evidence on which to base its findings to avoid a reversal on appeal for abuse of discretion, the party advocating a fact must prove it by a preponderance of the evidence. *Culpepper v. State*, 187 Ariz. 431, 435-438, 930 P. 2d 508, 512-515 (App. 1997). On this record, therefore, the Commission cannot charge ratepayers one cent for stranded costs for APS. The best it can do for APS/Pinnacle West shareholders, is to order that they have recovered more than stranded costs, and are fortunate

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[6]Using the Attorney General's stock market approach, the Commission's order would grant APS's shareholders 100% of their stranded costs by allowing them to keep their elevated values. Even if the market reacted negatively to the Commissions' order, under the Attorney General's proposal, the shareholders would be paid for the loss caused by the actual change to competition. (Lopezlira, direct testimony, Exh. A. G. 1, p. 8, l. 13-20.)

enough to keep the change. Any other order is clearly subject to reversal on appeal.

This form of having one's equity cake and eating it too, in the form of a guaranteed rate of return not subject to the effects of competition, became a common theme in the stranded costs testimony. As to other Affected Utilities, their net revenues lost approach, or their failure to offset the value of new market opportunities or other gains against stranded "losses", suffers from the same logical flaws as does APS's plan, although their equity owners may not have fared so well. The Commission may not lawfully protect any utility's position "going forward".

B. Where Loss of Equity is Possible, the Loss must be Measured by Offsetting Net Gains against Net Losses

The right, (in fact the only), determination of the stranded cost question as to APS shareholders is clear. Less clear is the question of how to handle TEP whose shareholders have not fared so well, and Citizens, to whom electric generation is a minor side-line to its principal business. Given the testimony in this record, it is evident that the stock valuation approach will not work for these two IOUs. However, divestiture of generation assets will work for TEP, and with the offset of restructure gains, for Citizens.

As to TEP, the stock valuation method will not paint a reasonably accurate picture of what shareholders have lost due to competition, as compared to what they have lost because of management error. TEP's stock already suffered from mismanagement, and it would be nearly impossible to sort out in this proceeding how much of an effect, if any, the threat of competition has affected its value. Further, the 90% debt load TEP carries cannot be ruled out as the cause for the loss of equity.

As has been shown, the right method for any Affected Utility is the one that minimizes stranded costs. For TEP, that method is clearly divestiture of generation assets. These depreciated assets, for example the Springerville plant could, in the current generation market environment, actually net book values or more, which would inure to the benefit of TEP's equity shareholders. A willing buyer will in fact consider the current financial position of TEP and how that affects the

power plant. A buyer will consider the value of the plants within his own scheme, and will determine how to make it profitable. His offer, therefore, will reflect the highest and best value the asset can achieve, and will correctly sort out what has going-forward value and what does not. This scenario is exactly what Dr. Block meant when he testified that the people with a financial stake in the outcome are best suited to assess the values of assets, and to obtain those values without regulatory involvement. (Block, 2/25/98, tr. p. 3469, l. 10-25, p. 3470, l. 1 -14.)

Citizen's shareholders face a different set of circumstances, but Citizen's planned divestiture should be well received. Citizen's proposed divestiture of the long term above-market power contracts with APS will surely improve its financial position. Citizen's stock is likely to rise upon that event alone, irrespective of the award of stranded costs, although the stock valuation change on the divestiture would be difficult to assess given that electric generation is not Citizen's core business. Citizens wants to be rid of a contract that is like a bad debt, taking whatever it can get from the sale in cash, and charging the difference to ratepayers. But Citizens' plan does not propose to offset the divestiture-enhanced equity the divestiture would create against the "stranded" loss. The record as to Citizen's situation supports divestiture, but does not support the calculation of stranded costs as the difference between the cash price of the APS contract and the cost of wholesale power, without considering the offsetting gains from reselling cheaper wholesale power. Losses must be netted against gains to avoid burdening the market with an overpayment to Citizens.

C. No Rational Economic or Legal Theory Mandates Payment of All Generation Costs

If the market sets the selling price, what then sets the cost? Under APS' and TEPs plans, the market is critical in establishing wholesale price, but becomes irrelevant when it comes to costs. In a competitive market, a company whose marginal cost is greater than the market price cannot survive. Yet APS and TEP want the Commission to require **ratepayers to pay all generation costs** until 2006, or later, with no questions asked, no matter how high the marginal costs, no matter how imprudent, taking on faith that the cost is a true cost of generation. This, says

Mr. Davis, is a plan based on "actual costs" and "market prices." (Davis, direct testimony, 1/9/98, p. 11, l. 9-10.) Under these plans, the cost of production becomes totally divorced from the price a willing buyer will pay, and the management bonuses and shareholder rates of return become a ratepayer-funded free ride.

Moreover, under these plans, the "market" chosen to dictate price is the wholesale market, essentially the lowest price at which power in the open market can be sold. The true retail market price, measured by any means, is considered irrelevant. This pick-and-choose method of using the market when it is convenient insures that the "stranded" loss will be as high as any set of numbers can make it, completely disregarding the essential point of allowing the "genius of the marketplace" to drive all firms to maximize efficiencies to produce at the lower market prices the competition has generated.

The efficiency benefit of the competitive market is the truest reason for moving toward it. Everyone who testified in the hearings admitted that efficiency is a desirable goal and said his or her plan included "incentives" to become efficient. TEP's expert, Dr. Gordon, perhaps best expressed the concept:

> And I think that what that is informed by the kind of regulation that has gone on in the past where rates are set so that you will only make your allowed rate of return in a traditional system, you know, if the management stretches itself, exercises full capability, meets its responsibilities in terms of being efficient, being prompt, being responsive and the like. If you don't meet those then you won't get it. You had your reasonable opportunity, but you didn't get it, so that has that philosophy, is what should apply in the case of stranded cost recovery as well.

(Gordon, 2/10/98, tr. p. 737, l. as above.)

It behooves the Commission to sort the true market-driven efficiency incentives from those that merely add to costs. In the APS plan, the "incentives" to economize are management bonuses, (Davis, 2/26/98 tr. p. 3763, l. 19 -25), to be guaranteed by ratepayers, along with the 11.25% shareholder rate of return whether or not APS gets its real generation costs any closer to the wholesale or retail market price of power.

Thus, in the "cost-plus" net lost revenues plans, costs are separated from real market earnings, and the most powerful cost-cutting incentive of all, that revenues will not be enough to pay for the cost of generation, is eliminated completely. This severance is unheard of in competitive markets, and is completely contrary to the Commission's goal of instituting retail competition.

> [W]hen you have cost plus regulation, you do tend to get inefficient costs because you don't have the discipline of a marketplace and any commission, no matter how well staffed or how competent, is not in the same position to impose the same discipline that an efficient competitor will impose. I think there was a chief executive of a utility once [sic] said the only business in the world where I can increase my profits is by remodeling my office.
>
> (Rosenberg, 2/18/98, tr. p. 2331; *see also*, Gordon direct testimony, 1/9/98, p. 15, l. 12-16.)

Of course the Affected Utilities net lost revenues plans do much more than afford a reasonable opportunity to recover stranded costs. Net loss revenue is merely a cash flow guarantee and, as such, is a tremendous barrier to competition. Using this methodology would

over-compensate the Affected Utilities, drive the retail price of power higher, preserve existing market power even for inefficient firms, delay technological advances and generate artificial cash flows to subsidize retail prices for incumbents, thereby, thwarting the delivery of truly cheaper power from efficient providers to the Arizona retail market. These plans create almost insurmountable barriers to entry, and wholly thwart the Commission's plan for competition. This Commission cannot, under its own rules, adopt the Affected Utilities net lost revenues plans. By adopting this approach, the Commission would be guaranteeing the market position of the affected utilities by insulating them from competition.

This may be the reason that APS's counsel attempted to set up a legal estoppel or waiver argument to force net loss revenues upon the Commission. The ploy was to have former Utilities Director Carl Dabelstein pretend to be an ordinary citizen appearing "pro per", and then to testify as an expert former Utilities Director that the "true" position of the Commission staff is foursquare in support of net loss revenue. Dabelstein, of course, was the employee of TEP before he became Utilities Director, (Dabelstein, direct testimony, 1/9/98, Appendix A, p. 2, l. 26-29, p. 3, l. 1-3), and clearly never lost the bias he necessarily developed there.

Because of this bias, Dabelstein testified under false pretenses and claimed that he invited all parties to have their say in the Stranded Cost Working Group, and no one successfully challenged his personal endorsement of net loss revenue. (E.g., Dabelstein, 2/12/98, tr. p. 1462 - 1478 .) The Stranded Cost Working Group Report was admitted over the objection of many other parties, for the potential purpose of "impeaching" the testimony of staff which has rightly adopted a much less radical, more market-reality based proposal. The report itself belies Dabelstein's testimony that the document was a product of some consensus. (*Id.*) Neither the report nor Dabelstein's personal preference for net loss revenue should be considered substantial evidence of its validity as an option for the commission.

The net loss revenue approach is neither consistent with the Commission's rules, nor with the so-called "regulatory compact" the Affected Utilities rely on. Indisputably, overcapacity in the generation product market is the cause of "strandable" costs. (Davis, direct testimony, 1/9/98, p. 10, l. 12-14.) Overcapacity, that is, excess supply, always drives prices down, as it has done in the

wholesale power market. This in turn means that needed megawatts can now be obtained in the wholesale market more cheaply than the cost of their generation. This is the environment into which the Commission[7] has already decided the Affected Utilities must operate. Having so determined, the Commission cannot now change the nature of stranded costs to make them future revenue guarantees.

Any "going-forward" cost of operation is not, prima facie, a "stranded cost". (Gordon, direct testimony, 1/9/98, p. 8, l. 26-29, p. 12, l. 9-12.) With the exception of the lost "brick and mortar" investment costs to be determined by a market measure of equity value, and the continued duty to serve obligations, no cost incurred after January 1, 1999, is a "stranded cost". Thereafter, these are costs of doing business in a competitive world. If the costs are too high, then losses may indeed occur. However, this Commission cannot lawfully "compensate" losses caused by competition, even by government-forced competition. *Laidlaw Waste Systems, Inc. v. City of Phoenix*, 168 Ariz. 563, 565-567, 815 P. 2d 932, 934-936 (Ariz. App. 1991), infra, at p. 15.

Net lost revenue, in the form advocated by TEP, APS, AEPCO, Navopache Cooperative and AUIA, is essentially a guarantee of profitability that compensates largely for expected future losses caused by competition. Once the investors are sure they have received the equivalent of their investment, the responsibility of this Commission and of the ratepayers ends. At the time the assets are valued, the extent to which investors are willing to take this risk will be measured and compensated as appropriate. Thereafter, their gains and losses will be driven by the fluctuations of markets, and subject, as in other industries, to changes in regulatory regimes and management decisions that may cost them money. This is simply a shareholder risk in capitalist markets, where no investor can reasonably expect to have his capital gains and fixed rate of returns paid in a competitive environment.

The Attorney General's view is that the independent shareholders and stock-owning company executives are entitled to keep the above-book equity that internal restructuring or savvy

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[7] And, it would appear, the Arizona legislature, which is likely to pass an amended version of House Bill 2663, deregulating public power generation and seeking continuity with the Commission for public service corporations.

management nets. They should absolutely not, however, be insulated from the future effects of competition on cash flows or rates of return. Every net lost revenue method advocated in this case proposes taking money from ratepayers unnecessarily, adding stranded cost charges which will artificially elevate retail electric rates and raise costly barriers to new competition.

III.

THE OVERWHELMING PREPONDERANCE OF THE EVIDENCE PROVES THE SUPERIORITY OF A MARKET-BASED METHOD OF CALCULATING STRANDED COSTS

A. Reliance on Market Values is Inherent in Every Stranded Costs Plan

> [A. by Mr. Meeks: I] don't know how the market feels about APS or TEP's ability to compete, and that's what it will boil down to.
>
> Q. It demonstrates, isn't it true, that the only entity who does know is the market?
>
> A. I would say that's probably true.
>
> (Meek, 2/27/98, tr. p. 4265, l. as above.)

A recurrent theme in the stranded cost hearings has been that the Commission should leave decisions about market values to those best suited to decide such questions. The Attorney General, APS, AUIA, the Goldwater Institute, Citizens, and the major competitors and virtually all the economists agree that management is best suited to make management decisions.

As Dr. Block said, those who have their own money at stake will make the shrewdest decisions possible. Those who invest in utilities[8] and those who buy power plants and power

[8] Some of whom, Mr. Meek finally admitted, may indeed be part of the "Gucci" crowd.

contracts for a living will, in every case, have better information about the transaction before entering into it than the Commission is likely to have. Mr. Fessler described this phenomenon when he talked about the divestiture certain California utilities voluntarily commenced, even without a Commission mandate. (Fessler, 2/10/98, tr. p. 423, l. 21-25, p. 424, l. 1 -21.)

Those who have no financial stake in the outcome will more often than not be mistaken. Regulatory, administrative, estimate-based determinations are called suspect even by those who recommend them. Former Utilities Director, Dabelstein, cited the need for true-ups in connection with "administratively determined stranded costs" because:

> There is considerable uncertainty in attempting to quantify stranded costs. The process is based on a number of factors that, at this point, are nearly impossible to predict. **It is pure speculation** to project what the markets and prices for power will be in the future.

(Dabelstein, direct testimony, 1/23/93, p. 20, l. 1-5.) Presumably, Mr. Dabelstein has no problem with the fact that the ratepayers pay for these exercises in "pure speculation". (Davis, 2/26/98, tr. p. 3884, l. 7-21.)

It may indeed be "nearly impossible" for Mr. Dabelstein to predict market behavior, but a sophisticated buyer of a power plant knows what questions to ask. Mr. Davis is quite sure he can predict the future of the market with sufficient certainty to intelligently buy a power plant, (e. g., Davis, 2/26/98, tr. p. 3887, l. 13-25, p. 3891, l. 1-25, p. 3891, l. 1), and to estimate the precise year that the industry's long-run marginal cost of generation will intersect with the market price. (Davis, direct testimony, 1/9/98, p. 10, l. 16-18.)

The Attorney General's approach proposes to leave management to management, investment and capital decisions to the financial markets, and power plant and power supply contract prices to the give and take of sophisticated buyers and sellers. The Attorney General is hardly a voice crying in the wilderness. Every proposal in this proceeding contemplates relying, in whole or in part, on this vast, (and free), storehouse of personal-interest expertise.

This is because the Commission can't get to "stranded" costs without relying on a "market". Every witness in this proceeding relied on some market or another in endorsing a

method of calculating stranded costs. APS's method of net lost revenues would measure costs against the California PX wholesale market price index. (Davis, direct testimony, 1/9/98, Schedule JED-2, l. 6.) TEP would use the Dow Jones Palo Verde Index. (Bayless, direct testimony, 1/9/98, p. 14, l. 23-24.) Citizen's would tap the short-term willing buyers of power sources market. (Breen, direct testimony, 1/9/98, p. 14, l. 8 -14.) AEPCO would rely on the "market price", if it falls relative to its own price, to define its possible stranded costs. (Edwards, 2/17/98, tr. p. 2039, l. 23-25, p. 2040, l. 1-2.) Dr. Cooper testified that the basic function of regulation is to "mimic the competitive market". (Cooper, 2/19/98, tr. p. 2453, l. 11-15.) RUCO's Dr. Rosen would use the "market price of generation" to determine the stranded cost to be apportioned to a particular consumer class. (Rosen, 2/17/98, tr. p. 1816, l. 10-18.) The industrial ratepayers' expert, Dr. Rosenberg, uses market values to test book values. (Rosenberg, 2/18/98, tr. p. 2189, l. 19-25, p. 2190, l. 1-2.) Other parties and experts rely on various market measures. Even Mr. Dabelstein, the most avid administrative devotee, feels compelled to rely on market prices to estimate annual revenues in his version of net loss revenues. (Dabelstein, prefiled testimony, p. 8, l. 22-29, p. 9, l. 1-10.)

Mr. Fessler described how in California, following great frustration, the legislature intervened and forced divestiture. The reason for this dramatic step is that there is no way, other than reliance on the market, to achieve the results the market can generate. Ms. Petrochko, of Enron, described how in the PECO stranded cost proceedings the regulators settled upon a rate reduction, which the competitor, Enron, promptly doubled in order to secure residential customers. (Petrochko, 2/12/98, tr. p. 1002, l. 7 - p. 1005, l. 10.)

The administrative approach is merely a proxy for the relevant markets. This Commission should adopt the simplest method of allowing the markets to speak the most directly, and get on to the real point of its restructuring Rules.

B. Only A True Market Determination of Value is Fast, Efficient and Offers Market Certainty

The Commission's intent is to start competition by 1999, and have it fully implemented by 2000. No administrative method can meet that deadline. If the stranded cost hearings are any

indication, there will not be enough time to complete even part of that plan by the end of 1998. Moreover, no one will really know what the CTC is going to finally be, or how much money this will cost ratepayers, for years.

RUCO's administrative approach will take fifteen (15) years or more to play out. Dr. Cooper may have the math right about when the stranded costs will become negative and the ratepayers can make back what they lost, but by then the harm to the budding competitive market will have been done. APS's plan for guaranteed revenues extends out seven (7) years, to the end of what APS calls the "market imbalance period. (Davis, direct testimony, 1/9/98, p. 3, l. 7-8, p. 10, l. 16-18.) By then, new technology may make gas plants obsolete and even power poles irrelevant.

The great weight of the evidence, from those who understand how competitive markets work, proves that the method, and the number, must be set now, this year. The payout term can be five (5) years long, but the uncertainty will prevent the true benefits of competition in the meantime. (Nelson, 2/27/98, p. tr. 4183, l. 16-25, p. 4227, l. 14-18.)

The most compelling argument for adopting a stock, or divestiture, or appraisal valuation plan, is that there is a short-term "buyers' market" phenomenon existing now. (Breen, prefiled testimony, 1/9/98, p. 14, l. 80-14.) For probably no more than two (2) years, TEP might be able to get book-plus for its generation assets. As new markets open in deregulating states, many parties will want to own capacity to get in on the new retail ground floor. If the Commission waits, or adopts a long-term " let's see how this works for a while and look at it again later methodology", it will have cost ratepayers millions of dollars. There is no evidence in this record that the best market for the sale of generation assets, (aside from nuclear), is any time but now. The Commission cannot, on this record, rule that short-term market valuations are not in the best interests of the ratepayers, big and small. It is the Commission's duty to protect those ratepayers.

C. Fairness Requires A Market Approach

It is difficult to see how TEP can claim, as Mr. Carroll did in his opening statement, (2/9/98, tr. p. 77, l. 16-22), that only the affected utilities and their shareholders have something to lose. Everyone has something to lose in this proceeding if the Commission's order goes too far

one way or another.

Only the market approaches minimize the risk of overcompensating the Affected Utilities. Whether or not deregulation involves a "regulatory compact" breach, it certainly at some point involves a taking of someone's property, but the taking is not limited to utility investors or cooperative owners. Overcompensation would be a truly improper transfer of wealth from ratepayers to affected utilities and their shareholders, as to whom the commission has "by a relationship developed over time ... created the legitimate expectation", (Fessler, 2/10/98/ tr. p. 512, l. 17-19), that the Commission will not pay more to the utilities than they are entitled to. Thus, by the reasoning of the parties basing their claims on a "regulatory compact", the Commission's unjustified transfer of wealth from ratepayers to insulate the utilities from competition would itself be an unlawful "taking".

The Attorney General does not argue that there is a "regulatory compact". However, there are government promises made to consumers, business big and small and, in this venue, to all ratepayers too, which include that there will be no such transfer of wealth. The regulatory compact of monopoly utility regulation, if there is one either *de facto* or *de jure*, is as much a promise to shield consumers of electricity from the windfall profits that monopolies necessarily can achieve, in exchange for the ratepayers' covenant to pay the bill, as it is to protect utility investors from the risk of equity loss. Thus fairness demands that, while utility investors do not have their investments rendered valueless by deregulation, ratepayers not pay more for "strandable" costs than the equivalent of asset book value.

To avoid overvaluing the shareholders' claim to net loss revenue as essential to "fairness", the Commission should keep in mind that there is **no independent shareholder** testimony before it. Mr. Meek is a good witness for APS and APS management stands to gain greatly from the approach Mr. Meek supports, but by his own admission, Mr. Meek on behalf of the Arizona Utility Investors Association is merely a shill, a counterfeit counterweight to RUCO, whose efforts before the commission on electricity matters are completely paid for by APS, and whose association with APS is concealed in marketing literature. (Meek, 2/27/98, tr. p. 4281, l. 16-25 through p. 4284, l. 1-12; Exhibit AECC, et. al., #6.) Mr. Meek, therefore, cannot be heard to speak

for fairness to shareholders who also hold stock in competitors of APS.

What is "fair" is what the market does. No one would argue that a person who finds that he cannot get his asking price on the sale of his home is treated unfairly by the system, and is entitled to government relief. The market, (the stock market, the retail power market, or the generation asset market), will necessarily generate "fair market value". Indeed this is the only fair "market" value there is.

D. Capital Will Not Dry Up if a Market Approach is Used

"It is entirely appropriate in my opinion -- indeed desirable -- to change *on a forward going basis* to a framework in which the **risk of prospective investments will be placed entirely on the shareholders**...." (Gordon, direct testimony, p. 8, l. 26-29.)

The Affected Utilities, other than Citizens, prediction that without application of their version of net loss revenue to stranded costs, capital will dry up, is a red herring. In his prefiled testimony, Mr. Meek predicts the end of capitalism as we know it, if 100% of stranded costs are not recovered. Yet he also agreed that APS/Pinnacle West stock rose $946 million dollars after the Commission determined to open generation to competition. The financial markets, (driven by people who have their own money at stake), have already decided that APS is a good investment even with competition coming, and capital has rained from the sky upon the company and its shareholders. (Exh. A.G. 4.)

The same can be said about the above-book sales of generation assets. These above-book-value buyers may be "suckers", to use Mr. Meek's vernacular, or they may be geniuses ahead of their times. Either way, right now capital is raining down upon companies with generation assets up for sale. The Commission must recognize from the testimony in this proceeding that now is as good a time to sell power plants as there is likely to be.

It may be true that an Affected Utility feels a particular type of capital may be at risk, (such as new, low-interest debt refinancing). This does not mean that capital will dry up, or that ratepayers and competition must pay for the best deal in capital availability. And, there are

situations where easy capital is already hard to find. The hard truth, and the truth to which ratepayers are entitled, is that TEP cannot now attract the kind of capital it needs to stay profitable in the competitive retail market. TEP, like any other strapped company, may have to sell to get cash to pay its bills, and, if one of its generation assets "cannot recover its avoidable cost, [TEP] can be expected to close it." (Hieronymus, direct testimony, 1/9/98, p. 22, l. 11-12.) If it sells soon, TEP may even net a gain for its investors.

Ratepayers simply do not owe the TEP shareholders a revenue stream with which it can restructure debt to the liking of management, nor is that a proper purpose for which to burden the competition with an inefficient, subsidized competitor with market power. It makes no economic sense to perpetuate a firm that is unable to operate profitably on its own, and no substantial evidence in this record would support the Commission's doing so.

E. Market Methods Permit A Simple Process

Although they have tried mightily, the Affected Utilities have been unable to really complicate the market approaches. The stock market approach is so simple and works so well for APS/Pinnacle West, that there is no evidentiary basis for disregarding it. No witness concretely identified any actual problem in terms of cost or delay occasioned by a simple coupon split off. The witnesses who touched on the mechanics of this approach said this was the most expeditious, simplest and most cost-effective measure. (Goldwater Institute, direct testimony, 1/21/98, p. 12, l. 22-24; Lopezlira, rebuttal testimony, 2/4/98, comprehensive summary, p. 2.) Of course, there has been such a meteoric rise in shareholder equity for APS/Pinnacle West, (Exh. A.G. 4), that there are zero stranded costs. The costs of administrating the zero repayment will likewise be zero.

Divestiture for TEP and Citizens and the other cooperatives can be effected by a very simple set of rules as follows:

1. Prepare a request for proposals by a date within ninety (90) days of the Commission's order, seeking offers to purchase the identified asset(s) which sets forth acceptable terms such as:

a. Reasonable payment form and duration

b. Financing options

c. Time frames to closure

2. Require that proposals be returned by a date certain within ninety (90) days.

3. Require that bidders be independent of the selling entity.

4. Prohibit acquisition by any entity holding market power in generation or distribution in a certificated geographic area in Arizona.

5. Sell to the highest responsible bidder upon obtaining regulatory approvals, but no later than a reasonable date certain. If the sale cannot close before the end of 1998, the values generated by the sale can nevertheless be determined by that time.

An appraisal method can likewise be rapid and efficient. The Commission can order the retention of a panel of three expert appraisals, one chosen by the Affected Utility, one by the Commission and the third by the other two. These appraisers would be directed to finish the job by a date certain before the end of 1998.

Where the greatest return from the divested asset is the financial gain from the reduction of liability, as may be the case with Citizens, the Commission should order that the financial benefit from the reduction of the liability be considered an enhancing return to the equity owners, thus reducing stranded costs. For example, if removing a burdensome liability does affect equity values held by owners, such as stock prices, these enhanced values should be offset against the loss on the sale of the asset.

IV.

IMMEDIATE, STATEWIDE OPEN ACCESS COMPETITION IS ESSENTIAL TO AVOID OVERPAYMENT OF STRANDED COSTS

The great weight of the evidence in the stranded costs hearings is that opening new markets sooner will make a huge difference to achieving the vision of competition that this Commission must have according to Mr. Fessler, (Fessler, 2/10/98, tr. p. 548, l. 2-5), the vision that Dr. Rosenberg described so clearly. (Rosenberg, 2/18/98, tr. 2225-2230.) This is because the greater,

(and the sooner), the opportunities for new sales become available to the Affected Utilities, the greater the reduction of stranded costs. (See Breen, 2/9/98, tr. p. 80, l. 8-10, p. 105, l. 25-29, p. 106 l. 1-7, p. 110, l. 11-12.)

It does not take a Ph.D. in economics to determine that if a company can sell a substantial volume of generated power in new markets its revenues go up, its cost of production per unit goes down, and its prices stay pegged to cost. If APS sells Palo Verde power at a retail, (not a wholesale), price to new customers in TEP's territory of Arizona by 2000, its stranded costs will be lower. If APS's stranded costs are lower, the CTC paid by its ratepayers will be lower. If the CTC is lower, there will be more room for competitors to offer residential consumers better rates than they had under regulation. If new competitors come in and take some of APS's old customers, then if APS sells at a retail price in Southern California, APS's stranded costs still are lower, the CTC charge in Arizona is lower, and so on.

The dramatic effect of new market opportunities is underscored by the remarkable absence of any actual consideration of the value of these opportunities to offset stranded cost. APS wants cost-less-wholesale price without reference to offsetting sales. Although Mr. Breen said that the Commission should offset the plus-assets with the minus assets, (Breen direct testimony, 1/9/98, p. 14, l. 12-14, p. 17, l. 7), Citizens seems to want cash value of over-market APS contract sale, structural financial benefit from freedom from its largest liability without offsetting the increased revenues and other market penetrations the low-cost power will enable it to make.

TEP failed to mention that it expects revenues from its retail storefront in Phoenix and its internal plans to market it SRP's territory in formulating its net loss revenue plan. TEP surely plans to try to sell power in AEPCO's territory south of Tucson.

There must be an opening of opportunities to market to new territories coincident to the commencement of competition. (Breen, 2/9/98, tr. p. 80, l. 8-10, p. 105, l. 25-29, p. 110, l. 11-21.) CC&Ns simply must go, not in a separate rule making docket but here and now, as a fundamental matter to be resolved before stranded costs are calculated. (Rosenberg, 2/18/98, tr. p. 2226, l. 24-25, p. 2227, l. 1-4; Lopezlira, direct testimony, 1/21/98 p. 4, l. 5-24.) There is ample evidence in this record that new market opportunities will go a long way to reduce stranded costs. This aspect

of the Attorney General's proposal, along with the essential implementation of non-discriminatory open access rules, (Rosenberg, 1/18/98, tr. p. 2226, l. 5-10; Lopezlira, direct testimony, 1/21/98, p. 6, l. 24-28, p. 7, l. 1-9), are perhaps the most important ones, and were endorsed by many in this proceeding. The Commission's order must provide for the elimination of the unwieldy CC&N process and entitlement, provide a FERC-type open access rule, and open the entire State to competition.

V.

SHARING STRANDED COSTS BETWEEN SHAREHOLDERS AND RATEPAYERS WOULD PROPERLY BALANCE RISKS AND MANAGEMENT INCENTIVES

Shareholders invested in APS, TEP and Citizens at times of risk, as evidenced by the negative consequence that befell TEP's stock when management chose the wrong, costly path. All shareholders assume a certain amount of risk. Mr. Meek admitted that the shareholders he represents understood that, as to generation, the Commission ordered a certain capacity, but management decided how to acquire it. It was management's choice to opt for long term wholesale market based contracts, or to build nuclear power plants. The shareholders did not know going in whether Palo Verde would be fully approved or whether any of TEP's coal-fired plants would be fully reimbursed. In fact, millions in Palo Verde costs were disallowed by the Corporation Commission. Yet the shareholders did not flee APS, they stayed. (Exh. A.G. 4.)

The Affected Utilities are saying that because they had to provide capacity, they are entitled to full stranded cost recovery, (in the vernacular of the Affected Utilities, stranded equals "unreimbursed"), even if its choice of facility to generate was management error, and even if the shareholders assumed some of the risk. Management of the IOUs, like the shareholder group, wants to "keep it coming" at the expense of ratepayers and to the detriment of competition.

VI.

ALL CUSTOMERS SHOULD PAY A METERS CHARGE BASED ON HISTORIC USAGE TO FAIRLY SPREAD THE BURDEN OF STRANDED COSTS

A meters charge is simplest and does not raise barriers to entry. Although there seems to be an inequity in the idea that a consumer who had an efficient utility may, if he moves, have to pay for a utility that was inefficient, the fact is that in a competitive market that happens all the time and no one is owed a duty to correct it. A person without a car may be relegated to a smaller, less efficient and more costly grocery store than one who can travel wherever triple-coupon values are offered.

The Attorney General provided the most detail in how to collect, bill for, and distribute the CTC. In Exhibit A.G. 3, the Attorney General described the initial billing statement, subsequent billing statement, how the CTC would be and who would manage the fund from which the stranded costs, (if any), would be distributed to utilities. Unlike Citizen's plan, the Attorney General does not recommend a separate bureaucracy, but merely a form of separate checking account.

There is no substantial evidence in this record that this simple method of allocating, billing and collecting is not feasible. If the Commission wants to keep its 1999 deadline, adopting this simple meters charge will do the job.

VII.

THE ATTORNEY GENERAL'S POST-HEARING ANSWERS TO THE COMMISSIONS NINE QUESTIONS

1. Should the Electric Competition Rules be modified regarding stranded costs, and, if so, how?

Yes. The Attorney General makes a number of recommendations for amendment. The most important of which are to clarify that generation and retail services markets are the product

markets to be deregulated, and the elimination of CC&Ns and amendment of percentages to open retail markets to competition statewide, with the CC&N procedure to be replaced by a licensing procedure. (See Lopezlira, direct testimony, filed 1/21/98, p. 3-7.)

2. When should Affected Utilities be required to make a stranded cost filing pursuant to AAC R14-2-1607?

Within thirty (30) days after the second stock evaluation has occurred, (APS); upon closing the sale of divested assets, (TEP, AEPCO, Citizens and the Cooperatives); upon the completion of an appraisal, (if that market method is chosen).

3. What costs should be included as part of stranded costs and how should those costs be calculated?

Any amount by which stock values, (APS), generation asset sale proceeds, (other Affected Utilities), or appraisal values, (if chosen), are below book value should be considered a stranded cost. See Exh. A.G. 3, copy attached, regarding the stock valuation method.

4. Should there be a limitation over the time frame over which stranded costs should be calculated?

The time frame is the before-and-after-rules-finality for the stock split, (see Exh. A.G. 3), the customary time frames for calculating book values at the time of sale or appraisal finality.

5. Should there be a limitation on the recovery time frame for stranded costs?

Yes. Five (5) years. (See Exh. A.G. 3.) Any market-based method can be handled in the same way and within the same time frame as the stock market method set forth in Exhibit A. G. 3.

6. Who should pay for stranded costs and who, if anyone, should be excluded from paying for stranded costs?

Every user of power at the time competition begins, based on historical usage. The charge

should be a "meters" charge based on location of the meter, not the customer, although it may be necessary to charge future customers to spread the burden. No one should be excluded.

7. Should there be a true-up mechanism and, if so, how would it operate?

No. None will be needed with the market approach.

8. Should there be price caps or a rate freeze as part of the development of a stranded cost recovery program and, if so, how would it be calculated?

No. Rate caps and freezes distort the markets and create artificial parameters around retail prices. Rate caps and freezes can drive prices higher and become barriers to entry.

9. What factors should be considered for "mitigation" of stranded costs?

Offsetting benefits such as gains in shareholder stock value; gains in value of generation assets realized on sale; equity gains from elimination of burdensome power contracts. Gains from potential sales of power in new retail markets will naturally be considered by market buyers and investors. If a market approach is not used, such gains should be offset against stranded costs calculated in any other way.

VIII.
CONCLUSION

This proceeding has proved one fact conclusively - there are available a number of fast and efficient market-based methods of valuing stranded costs that will correctly balance the equally-important interests of utilities' investors in recovering their stranded costs, of ratepayers in not overcompensating investors, and of the Commission, in moving toward competition. The market-based methods proposed here fulfill the regulatory promises made, if any, protect consumers from overpayment, do not artificially distort the future market, do not reward inefficiency, do not create barriers to competitive market entry or protect monopolies. Article 14, § 15 of the Arizona

Constitution says that monopolies shall not be permitted in this State. Although regulated monopolies are lawful, the preservation of monopolies in a competitive environment is not.

The good and timely decision to move to competition has been made. Now, the Commission needs to complete the process. The record in these proceedings requires this Commission to employ that market-based method of awarding stranded costs most likely to minimize the costs and, therefore, the burden on the future. The citizens of Arizona have the right to expect no less.

RESPECTFULLY SUBMITTED this 16th day of March, 1998.

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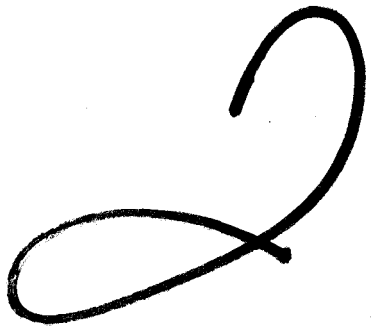

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
COMMISSIONER-CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. RE-00000C-94-0165

ATTORNEY GENERAL'S EXCEPTIONS TO PROPOSED OPINION AND ORDER

Pursuant to the relevant Procedural Orders, the Attorney General hereby submits the following exceptions and objections to the proposed Opinion and Order issued May 6, 1998 in the above-captioned matter.

1. The Proposed Opinion and Order fails to Consider Stranded Costs' Effect on Competition

The Proposed Opinion and Order acknowledges that the Commission has already determined that a transition to "competitive" generation will result in "lower prices, better service, more choices and increased competition." Proposed Opinion and Order (hereafter "Opinion") at p. 5, l. 1-5. While the Commission Restructuring Rules (hereafter "Commission's Rules") may need a clearer vision of what competition must look like, (Fessler, 2/10/98, p. 453, l. 20-25, p. 448, l. 19-20), they at least commit to competition. The Opinion recommends a full retreat to an unworkable regulatory regime.

Stranded costs unquestionably distort the marketplace (Goldwater Institute direct testimony, p. 12, l. 2-3) and have the direct impact of causing higher prices. Stranded costs are barriers to entry. Yet the Opinion nowhere even considers whether its stranded cost determinations aid or interfere with competition. Worse, the Opinion ignores the significant impediments to competition that will occur if it is adopted. The Opinion, by redefining stranded costs as "lost revenues", and by inventing a

"failing firm" rescue mechanism, not only abrogates the definitions already adopted in the Commission's Rules, but also imposes new regulatory barriers to competition. The Opinion cannot be adopted by the Commission if it is to be true to the letter and the spirit of the Commission's Rules.

As the Attorney General has urged in these proceedings, if the Commission wishes to advance competition, one of its most significant roles is to de-regulate, by removing regulation and administrative process where only the discipline of the marketplace is required. (Goldwater Institute direct testimony, p. 12, l. 2-3.) To do this, the Opinion should have considered and determined, both in findings of fact and conclusions of law, whether each stranded cost valuation and payment proposal imposed barriers to competitive entry or impediments to technological advance, before determining the appropriate mechanism. The Commission's implementation of the Opinion could be successfully challenged as unlawful or unreasonable because the Opinion is not based on substantial evidence and, in fact, completely disregards much of the evidence presented at the month-long stranded costs evidentiary hearing. *Litchfield Park Service Co. v. Arizona Corp. Comm'n*, 178 Ariz. 431, 434, 874 P.2d 988, 991 (App. 1994).

The principal problem with the Order is that it neglects to ask the first question - whether stranded costs should be paid at all, in light of the competitive and technological circumstances of today. [1] The Opinion presumes that some stranded costs must be paid, and supports this presumption by redefining stranded costs in total disregard for the Commission's Rules, which define stranded costs as:

> ...the verifiable net difference between:
>
> > a. The value of all the prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchased power contracts, fuel contracts, and

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[1] The Order does use the words "if any" once following the words "how much". (Opinion, p. 6, l. 18.) The "if any" then disappears from the discussion and does not appear in the findings and conclusions.

> regulatory assets), acquired or entered into prior to the adoption of this Article, under traditional regulation of Affected Utilities; and
>
> b. The market value of those assets and obligations directly attributable to the introduction of competition under this Article.

A.A.C. R14-2-1601. The Opinion, however, redefines stranded costs as the "difference between market based prices and the cost of regulated power." (Opinion, finding 8, p. 21, l. 3-4.) Thus, the Opinion is wholly circular, with the conclusion that lost revenues are a permissible methodology for stranded cost calculation following from the premise that stranded costs are lost revenues.

The Attorney General, competitors, consumer groups and other interested parties amassed clear and substantial evidence that the lost revenues methodology impedes the move to competition. Not only does the Opinion wholly fail to address the weight of this evidence, it completely disregards whether its recommendations help or hurt the move to competition.

2. The Opinion Awards More than Return of Lost Equity and Creates an Unlawful Transfer of Wealth to Affected Utilities.

The Opinion's redefinition of stranded costs as the equal of lost revenue, measured by generation price less market price, not only contravenes the policy but contradicts the evidence on the justification for the award of stranded costs of any amount. The great weight of the evidence, indeed virtually all of the evidence on this point, is that the only justification for stranded costs is a loss of owner/investor equity caused by competition.

As the Attorney General stated in his post-hearing brief, shareholders are the real "owners" of the investor owned utilities, (Meek, 2/27/98, p. 4251, Block, 2/25/98, p. 3551, l. 21-25, p. 3552, l. 1-8; Davis, 2/26/28, p. 3827, l. 14-15) and with or without a "regulatory compact" theory [2], the only

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[2] There is little support for regulatory compact theory in law or in economics. In any event, an economic loss from competition, even where it reduces investors' expected return, and even if it is allegedly unfair competition by the government, is not a constitutional "taking." *Laidlaw Waste Systems, Inc. v. City of Phoenix*, 168 Ariz. 563, 565-67, 815 P.2d 932, 934-36 (App. 1991). A reasonable opportunity to recover the value of property "taken" by government is, in the

rational justification for stranded cost recovery is the view that the owner/shareholders have lost the equity they enjoyed or the opportunity to recoup high returns if things go well because the regulators have changed the entire utility environment by moving to competition. (Block, 2/25/98, p. 3551, l. 21-25, p. 3552, l. 1-23; Goldwater Institute direct testimony, p. 9, l. 4-11.). Awarding stranded costs based on management decisions or market events, however, is not justified. APS' own expert testified that the utilities' owners are entitled only to a "reasonable opportunity" to recover "100 percent of those shareholder funds that they have invested in plant and equipment that may be strandable owing to the Commission's decision to introduce competition in Arizona" (Fessler, 2/10/98, p. 458, l. 19-21). Mr. Fessler also said that recovery itself "was never a 100% guaranteed result" (*Id.*, p.459, l. 9-10). TEP's expert conclusively stated that any future gains, profits and losses (other than continuing Commission mandates) are no part of the stranded costs equation. (Gordon direct testimony, 1/9/98, p. 12, l. 9-12.) The Commission cannot on this record lawfully award any amount of stranded costs beyond that which repairs lost equity, and even then, it can only award stranded costs if the loss is caused by the move to competition and not by mismanagement.

The Opinion ignores the great weight of evidence, the definition of stranded costs set forth in the Commission's Rules, and wholly accepts APS' and TEP's argument and claim that revenue protection equals equity protection until the "market imbalance" is over in 2006. (Davis direct testimony, 1/9/98, p. 10, l. 10-20.) Moreover, the Opinion goes even further by ignoring the question of whether there has been a loss of equity at all in its redefinition of stranded costs as lost revenues.

The Opinion thus accepts a measure of stranded costs that necessarily rewards management for inefficient costs, preserves a future competitive position or market share and protects future equity positions from the effects of competitive market prices. The Opinion clearly overcompensates

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constitutional sense, only an "adequate process for obtaining compensation", not a fixed amount of money. The "adequate process can be, as it is in this docket, a process provided by a State. *Williamson County Regional Planning Comm'n v. Hamilton Bank of Johnson City*, 473 U.S. 172, 194-95 (1985).

shareholders to the detriment of ratepayers and taxpayers. The Opinion's recommendation to guarantee a revenue stream is not supported by substantial evidence in this record and adopting the Opinion would therefore be an abuse of the Commission's discretion. See, *Pima County v. Pima County Merit System Comm'n*, 189 Ariz. 566, 944 P. 2d 508, (App. 1997); *Havasu Heights Ranch and Development Corp. v. Desert Valley Wood Products, Inc.*, 167 Ariz. 383, 807 P. 2d 1119 (App. 1990).

By adopting this Opinion, the Commission would engage in an unlawful transfer of wealth and would essentially impose a tax on individual consumers and business customers. By abandoning the record and redefining the entire premise for stranded costs out of existence, the proposed Opinion uses faulty reasoning that has a predetermined outcome--providing insurance against competition. This is not the result the Commission's Rules either envision or permit.

3. The Opinion Abdicates the Responsibility to Promote Competition and Protect Consumers

The Opinion offers the Affected Utilities lost revenues choices which concede that the primary objective of stranded costs is to protect the self-interest of the AUs, whether or not that self-interest is good for consumers or good for competition. Net loss revenue, even as modified, protects the inefficient high-cost provider from the "discipline of the marketplace." No witnesses, other than current or former AU employees or their paid experts, testified that net loss revenue, without a true incentive for management to change by becoming lean and competitive, is in the interest of consumers, competitors, business users or competition as such.

The Opinion offers these options without first determining whether the option will enhance competition or hinder it and without putting into effect free-market incentives that, once in play, will move management to decide what to do in a competitive environment rather than a protected one. If any proposal or aspect thereof slows the process down, calls for additional regulation, or transfers the risk of future competition away from the Affected Utilities and their competitors to ratepayers, the Commission must reject it. (See Gordon, direct testimony, 2/10/98, p 4, l. 2-27.)

The reduction of net loss revenue guarantees does not create these incentives nor does it recognize their importance. The market offers the proper incentives. (Gordon, 2/10/98, p. 737, l 3-14; Rosenberg, 2/18/98, p.2225-2230). The Opinion assumes "growth" will make up the difference so that the AU choosing net loss revenue does not, in its internal projections and decisions, have to act like real revenue changes are expected. In the lost revenues and "failing firm" options the Opinion recommends, the "incentives" to economize are management bonuses (Davis, 2/26/98 tr. p. 3763, l. 19-25) along with the guaranteed shareholder rates of return, whether or not any IOU gets its real generation costs any closer to the wholesale or retail market price of power. Economists who testified recognized that it is the "genius" (Fessler, 2/10/98, p. 453, l. 20-25, p. 448, l. 19-20) or "discipline of the market", which monopolies especially lack, that will produce the consumer benefit, (Goldwater Institute direct testimony, 1/9/98, p. 11, l. 25-26; see also Rosenberg, 2/18/98, tr. p. 2331; Gordon direct testimony, 1/9/98, p. 15, l. 12-16) and not the promise that in competition the monopoly utilities will "make up" what they would have gotten under regulation through growth burdens on consumers and barriers to entry.

4. There is No Evidence to Support the "Financial Integrity Option"

A fact of free markets is that firms sometimes fail. While the Commission may be obliged to keep certain essential or must-run plants operating, there is no basis to keep a failing *generation* utility alive and profitable by revenue guaranties. This "option", which forces consumers and business customers to pay off the debts of bad management, is wholly inconsistent with the Commission's Rules and with the move to competition.

The Opinion rightly notes that divestiture is an appropriate option. Thus, if an Affected Utility is failing, it should sell its generation assets to a company who is better able to profit from the assets now, during the current window of divestiture-opportunity, (Breen, direct testimony, 1/9/98, p. 14, l. 80-14) and recoup what it can. The Commission can protect the *distribution* assets of the failing firm through continued regulation.

It is unheard of in competitive marketplaces to protect failing firms from future competition (as compared to paying back investor losses). The rescue of a firm that cannot compete successfully is simply not within the power or responsibility of the Commission. To adopt an Opinion containing this option would be a clear abuse of discretion.

Conclusion

The Opinion recommends lost revenues in two of its three options. Using this methodology would over-compensate the Affected Utilities, drive the retail price of power higher, preserve existing market power even for inefficient firms, delay technological advances and generate artificial cash flows to subsidize retail prices for incumbents thereby thwarting the delivery of truly cheaper power from efficient providers to the Arizona retail market. These consequences, supported by the record but ignored by the Opinion, are contrary to the Commission's Rules.

For the foregoing reasons, the Attorney General urges the Commission to reject the proposed Opinion and Order, direct that it be revised to eliminate lost revenues and "failing firm" stranded cost valuation methodologies and that it consider the impacts of stranded cost awards on competition.

RESPECTFULLY SUBMITTED this 29th day of May, 1998.

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